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ESG Impact Assessment: Sell & Buy Side

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ESG CHEAT SHEET

INTRODUCTION

In the last few years, momentum has gathered in the finance industry to play a part in pursuing a better and more sustainable future for all. We set out here the primary pieces of financial service regulation that are driving ESG and how this applies to buy side / sell side firms.

WHAT ARE ESG FACTORS

ESG (in particular, climate change) is no longer a corporate social responsibility issue but one where financial risks emerging from climate change, amongst others, ought to be embedded in the governance and risk management frameworks of firms:

**E**

Environmental considerations relating directly to the climate or our environment, such as a company's level of greenhouse gas emissions.

**S**

Social issues concerning matters relating to employees and wider stakeholders, with areas of focus including human rights, health and safety and child labour, anti-corruption and bribery.

**G**

Governance issues relating to how a company is run and held accountable and including areas such as: board composition, board effectiveness, executive pay, shareholder rights, and diversity and equal opportunities.

WHAT IS THE EUROPEAN APPROACH TO ESG

Europe's political targets on climate change are set out in the European Green Deal. Before the Green Deal, the European Commission launched the EC Action Plan on Financing Sustainable Growth which is the European Union's blueprint for how those political targets will be achieved within the financial industry.

The EC Action Plan has led to a number of regulatory initiatives that we will set out in more detail in this document.

There are three main goals under the EC Action Plan to:

1. re-orientate capital flows towards a more sustainable economy;
2. maintain sustainability in risk management; and
3. foster transparency and long termism.

These goals are then broken down into different work streams which the European Commission has identified as being required in order to achieve those goals. Some of these initiatives are already in progress or indeed in force, while others are yet to apply. A summary of some is set out below which we will go on to look at in more detail in this document.

WHAT IS THE UK'S APPROACH TO ESG?

The UK government has set specific targets with the aim of the UK transitioning to a net zero carbon economy by 2050. The UK regulators such as the FCA, PRA and the FPC, have been clear as to the necessary approach on climate change within the financial industry.

Both the PRA and the FCA co-chair the Climate Risk Forum, an initiative designed to share best practice in relation to the financial risks from climate change.

The focus for the UK regulators is on climate change as a risk to financial services firms, the governance required to manage such a risk and the disclosures required to improve transparency on what companies are doing in this area. In this way, the UK government has taken a different approach to the European Commission in terms of the future of ESG regulation. The UK government is not onshoring the Sustainable Finance Disclosure Regulation, although it has onshored the Low Carbon Benchmark Regulation. With respect to the EU Taxonomy Regulation, the UK government has announced that it intends to develop its own taxonomy framework although it is not clear whether this will follow the European proposals, at least in structure, if not in substance. Any form of UK taxonomy is likely to diverge at policy level as to what can and cannot be considered as environmentally sustainable (take nuclear energy for example which the UK government considers is necessary to achieve climate targets, but which Europe does not consider as being an activity which can be determined to be green).

Instead, the UK government has made it clear that following Brexit it wants firms to pursue TCFD (Task Force on Climate Related Financial Disclosures) standards in terms of climate reporting. This is likely to come as a relief to firms who may struggle with European-like disclosure requirements particularly where there is potential divergence, notwithstanding that such European requirements may apply to firms marketing products into Europe.

For these reasons, UK firms will need to have one eye on the UK and one eye on Europe with respect to these developments.

WHICH EUROPEAN REGULATIONS WILL APPLY TO YOU?

Importantly, the different ESG obligations under the various European Regulations will apply to different market participations, A summary is provided below.

Entities	Benchmark administrator	Benchmark users				Collectively “financial market participants”		
		UCITS ManCo	AIFMs	MiFID Managers	MiFID firms			
Regulations	Carbon Benchmark Regulations						Obligations	Applicable to UK FMPs?
		Taxonomy Regulations				} Disclosure obligations		Yes – UK BMR applies
		Sustainable Finance Disclosure Regulations						No - unless UK AIFM marketing into EU
		Shareholders Rights Directive				} Develop engagement policy, transparency requirements for investment decisions and performance	Yes	
		Non-Financial Reporting Directive			} Disclosure obligations	Yes		
			Investment Firm Regulations / Directive		} Reporting on ESG risk, specific prudential treatment of ESG related assets, supervisory review of ESG risk	Yes		
			Capital Requirements Regulation / Directive		} Disclosure of ESG risk, ESG may become part of SREP, prudential treatment of ESG related assets may change	Yes, FCA has indicated		
			MiFID II		} Suitability obligations	No, and HM Treasury has not announced whether		
			AIFMD		} Incorporation of sustainability risks within: organisational procedures, collective responsibility of senior managers, conflicts of interest, due diligence requirements, risk management	No, and HM Treasury has not announced whether similar UK rules will be introduced		
		UCITS Directive				No, and HM Treasury has not announced whether similar UK rules will be introduced		
			PRIIPS		} Develop policy specifying scope of ESG targets, investment strategy which beings about the policy, and related systems and controls	No		
			Prospectus Regulations		} Disclosure obligations	Yes		



Background to European ESG measures

Following on from its EC Action Plan, on 24 May 2018, the European Commission ("**Commission**") adopted a package of measures on sustainable finance.

The package included:

- (a) the Taxonomy Regulation (Regulation (EU) 2020/852), which entered into force on 12 July 2020, and aims to establish an EU-wide classification system or "taxonomy" of environmentally sustainable activities, this will lead to a more objective assessment of whether a financial product or firm can be deemed "green" or "environmentally sustainable" by way of a "taxonomy compliant" score;
- (b) the Sustainable Finance Disclosure Regulation (Regulation (EU) 2019/2088) which entered into force on 29 December 2019 and will begin to apply from 10 March 2021, will require EU financial market participants and financial advisers (including investment firms providing portfolio management and/or financial advice, AIFMs, pension providers or insurance undertakings) to disclose how ESG factors are taken into account in investment decision-making processes and advisory processes; and
- (c) the Low Carbon Benchmark Regulation (Regulation (EU) 2019/2089 amending Regulation (EU) 2016/1011) which entered into force on 10 December 2019 and amends the European Benchmark Regulation by creating two new categories of benchmarks, Paris-aligned benchmarks ("PABs") and Climate transition benchmarks ("CTBs"), which will help investors monitor the performance of their underlying investments against the targets set by the Paris Agreement on climate change, as well as requiring disclosure of ESG considerations in benchmark statements and methodologies.



In addition, the Commission had sought feedback on:

- (a) a proposed Delegated Regulation amending Delegated Regulation (EU) 2017/565 (the MiFID II delegated regulation) requiring investment firms to have policies and procedures in place in order to gather clients' sustainability preferences and ESG considerations preferences into the advice and portfolio management that they offer to individual clients; and
- (b) potential amendments to Commission Delegated Regulation 231/2013 (AIFMD Delegated Regulation) and Commission Delegated Directive 2010/43/EU (UCITS Delegated Directive).

Following the public consultations, the Commission intends to adopt these amendments.

In relation to the above, and pursuant to the mandate granted to it by the Commission, ESMA has published:

- (a) a final report on the integration of sustainability risks and factors in MiFID II, following the adoption of the Disclosure Regulation; and
- (b) a final report advising on amendments to Commission Delegated Regulation 231/2013 (AIFMD Delegated Regulation) and Commission Delegated Directive 2010/43/EU (UCITS Delegated Directive) to require authorised EU fund managers and UCITS management companies to evaluate the sustainability risks of their investments, and integrate sustainability risks and factors into the processes and procedures.

Taxonomy regulation

THE TAXONOMY REGULATION WILL ESTABLISH AN EU-WIDE CLASSIFICATION SYSTEM (OR TAXONOMY) INTENDED TO PROVIDE FIRMS AND INVESTORS WITH A COMMON FRAMEWORK FOR IDENTIFYING TO WHAT DEGREE ECONOMIC ACTIVITIES CAN BE CONSIDERED TO BE “ENVIRONMENTALLY SUSTAINABLE”.

WHAT IS IT? WHO DOES IT APPLY TO?

On 12 July 2020, the EU Regulation on the Establishment of a Framework to Facilitate Sustainable Investment (widely referred to as the Taxonomy Regulation) entered into force, marking a significant step in the realisation of the EC Action Plan.

Note that the UK government has indicated that it will introduce its own taxonomy regime. This may take a similar form to the EU regime but is likely to have different underlying technical screening criteria against which firms will need to calculate their “taxonomy compliance”.

The Taxonomy Regulation introduces an EU-wide classification system (or taxonomy) of environmentally sustainable activities.

The Taxonomy Regulation sets out the criteria for determining whether an economic activity constitutes an environmentally sustainable activity. This is intended to alleviate the burden on investors’ own due diligence with regard to a product’s environmental sustainability and eliminate the practice of greenwashing (where financial products are inaccurately marketed as “green” or “sustainable”).

The Taxonomy Regulation builds on the work of the Technical Expert Group on Sustainable Finance (“TEG”). The Taxonomy Regulation recognises six distinct environmental objectives (“Environmental Objectives”):

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control; and
6. protection and restoration of biodiversity and ecosystems.

Under the Taxonomy Regulation, an economic activity can constitute an environmentally sustainable activity if it:

1. contributes substantially to one or more of the Environmental Objectives, or directly enables other activities to make a substantial contribution to one or more of them;
2. does not significantly harm any other Environmental Objective;
3. complies with applicable technical screening criteria (“Technical Screening Criteria”) set out in delegated acts that are being developed; and
4. is carried out in compliance with certain minimum safeguards.

The Technical Screening Criteria will be built up gradually over time through delegated acts supplementing the Taxonomy Regulation, and will be used to determine whether an economic activity can be considered sustainable.

Article 8 of the Taxonomy Regulation requires non-financial undertakings under the Non-Financial Reporting Directive (“NFRD”) to disclose the proportion of their turnover, capital expenditures (CapEx) and operating expenditure (OpEx) associated with environmentally sustainable economic activities, consistent with the EU taxonomy. Such disclosure will be in the form and with the content and methodology as set out by the Commission (to be adopted by way of delegated act under Article 8(4) by 1 June 2021).

IMPACT - BUY SIDE

- EU fund managers (e.g. AIFMs, UCITS management companies) will be in scope of the Taxonomy Regulation as financial market participants, as well as those non-EU fund managers who market their fund into the EU (e.g. under article 42 AIFMD NPPR).
- Where a fund manager has a fund which is an article 8 or an article 9 fund (i.e. promotes environmental or social characteristics or promotes sustainable objectives) under the Disclosure Regulation, (a) relevant calculations will need to be made under the Taxonomy Regulation provisions and (b) disclosures made under the Disclosure Regulation (articles 5 and 6 Taxonomy Regulation).
- Where a fund manager does not have an article 8 or article 9 Disclosure Regulation fund, a statement will need to be made noting that 'The investments underlying this financial product do not take into account the EU criteria for environmentally economic activities' (article 7 Taxonomy Regulation). No calculation will be required under the Taxonomy Regulation
- Fund managers ought to consider the Taxonomy Regulation in light of MiFID II product governance amendments ([see section 6 below](#)) and AIFMD amendments ([see section 7 below](#)).
- Where the Taxonomy Regulation applies, more scrutiny will be needed with respect to the data required under the Taxonomy Regulation in order to make the necessary assessment and in particular how to ensure that any underlying investee.

IMPACT - SELL SIDE

- Investment firms and credit institutions that provide portfolio management services will have to make calculations under the Taxonomy Regulation and make disclosures under the Disclosure Regulation.
- Issuers under the Prospectus Regulation will be required to make calculations under the Taxonomy Regulation (under article 2(4)).
- Sell side firms caught as manufacturers under MiFID II amendments will be impacted by the Taxonomy Regulation proposals on the calculation of what can and cannot be deemed to be sustainable. Product governance processes and procedures will need to be updated, for example to reflect taxonomy assessments and target market updates.
- We expect sell side firms to pay attention to the Taxonomy Regulation when they sell a product as "green" or "sustainable". As a result, more scrutiny will be needed on the data that can be provided for underlying investments or portfolios with respect to the calculations needed under the Taxonomy Regulation and the output of such impact on the market appetite for such products.
- Manufacturers or providers of certain pension products or insurance based investment products (IBIPs) will be in scope of the Taxonomy Regulation.

ISSUES TO BE CONSIDERED FURTHER

The Taxonomy Regulation will also apply to Member States for the purposes of any measure setting out requirements for financial market participants or issuers in respect of financial products or corporate bonds that are made available as environmentally sustainable. It will also apply to corporates under the Non-Financial Reporting Directive.

Non-EU companies may also find that their European shareholders (who may, as financial market participants, be subject to disclosure obligations under the Taxonomy Regulation) apply pressure to provide sustainability-related disclosures to enable such shareholders to fulfil their own disclosure obligations.

DEFINITIONS

Environmentally sustainable investment means an investment in one or several economic activities that qualify as environmentally sustainable under the Taxonomy Regulation.

Financial market participant has the meaning given to it in the Disclosure Regulation ([see section 2 below](#)).

Financial product has the meaning given to it in the Disclosure Regulation ([see section 2 below](#)).





EU TIMELINE

The first set of Technical Screening Criteria, for activities which substantially contribute to climate change mitigation or climate change adaptation, will apply from 1 January 2022. The second set of Technical Screening Criteria, which cover economic activities substantially contributing to the four remaining Environmental Objectives, will apply from 1 January 2023.

Delegated acts will be adopted.

In respect of climate change mitigation and climate adaptation, the following disclosure provisions broadly apply from 1 January 2022 (by virtue of amendments made by the:

- Transparency of environmentally sustainable investments in pre-contractual disclosures and in periodic reports (article 5);
- Transparency of financial products that promote environmental characteristics in pre-contractual disclosures and in periodic reports (article 6);
- Transparency of other financial products in pre-contractual disclosures and in periodic reports (article 7);
- Transparency of undertakings in non-financial statements (article 8).

Disclosure provisions described above apply from 1 January 2023 in respect of: the sustainable use and protection of water and marine resources; the transition to a circular economy; pollution prevention and control; the protection and restoration of biodiversity and ecosystems.

UK TIMELINE

While the provisions in the Taxonomy Regulation do not take effect until after the end of the transition period, the UK government has indicated that it will introduce its own taxonomy regime. This may take a similar form to the EU regime but it is likely to have different underlying technical screening criteria against which firms will need to calculate their “taxonomy compliance”. For example, it is likely – given the government’s announcements in November 2020 – that nuclear energy will be deemed to be environmentally sustainable in the UK.

Therefore, firms will need to monitor how and when the UK regime is developed and what divergence there is with the EU if they are firms which operate in both markets/have UK and EU clients.

The UK has onshored certain provisions in the Taxonomy Regulation relating to those parts which already apply under the EU Taxonomy Regulation via Statutory Instruments. This includes provisions relating to the deadline for the development of Technical Screening Criteria, which is amended in the UK by the Securities Financing Transactions, Securitisation and Miscellaneous Amendments (EU Exit) Regulations 2020 (SI 2020/1385) from January 2021 to January 2023 for the first 2 environmental objectives (climate change mitigation and climate change adaptation) and from January 2022 to January 2024 for the other 4 environmental objectives.



SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852	<p>Consultation paper (ESMA30-379-325) on 5 November 2020 setting out draft advice to the European Commission on Article 8 of the Taxonomy Regulation specifying the content, methodology and presentation of the key performance indicators (KPIs) that non-financial undertakings and asset managers are required to disclose.</p> <p>https://www.esma.europa.eu/sites/default/files/library/esma30-379-325_consultation_paper_-_draft_advice_to_ec_under_article_8_of_the_taxonomy_regulation.pdf</p> <p>Draft Commission Delegated Regulation supplementing the Taxonomy Regulation relating to climate change mitigation and adaptation published on 20 November 2020 (pursuant to Articles 10(3) and 11(3) of the Taxonomy Regulation). This specifies technical screening criteria for determining the conditions under which a specific economic activity qualifies as contributing substantially to climate change mitigation or climate change adaptation, respectively, and to establish, for each relevant environmental objective laid down in Article 9 of the Taxonomy Regulation, technical screening criteria for determining whether that economic activity causes no significant harm to one or more of those environmental objectives.</p> <p>https://ec.europa.eu/finance/docs/level-2-measures/taxonomy-regulation-da-2020_en.pdf</p>	None to date

OVERLAP WITH OTHER ESG REGULATIONS

The Taxonomy Regulation makes amendments to the Disclosure Regulation and correlates closely with the Disclosure Regulation, although there is not complete alignment between the two.

Disclosure Regulation

THE DISCLOSURE REGULATION ESTABLISHES DISCLOSURES TO BE MADE BY CERTAIN FINANCIAL FIRMS IN RELATION TO HOW THEY INTEGRATE ESG FACTORS INTO INVESTMENT DECISION MAKING PROCESSES AND IN RELATION TO PRODUCTS WHICH PROMOTE ENVIRONMENTAL AND/OR SOCIAL CHARACTERISTICS OR PURSUE ENVIRONMENTAL OBJECTIVES.

WHAT IS IT? WHO DOES IT APPLY TO?

The Disclosure Regulation seeks to harmonise existing provisions on disclosures to investors in relation to sustainability-related disclosures by imposing requirements on **financial market participants** (e.g. AIFMs and UCITS management companies and investment firms or credit institutions carrying out portfolio management) and **financial advisers** (firms authorised under MiFID or Solvency II to give investment or insurance advice and credit institutions) in relation to financial products.

The Disclosure Regulation requires information to be made available either at entity level or at product level, **irrespective of whether sustainability risks are integrated into financial market participants' investment decision-making processes or, advisory processes**. Further measures seek to increase transparency as regards financial products which target sustainable investments, including reduction in carbon emissions.

Note that the UK has indicated that it will not be onshoring the Disclosure Regulation and instead the UK government has laid out plans to mandate TCFD reporting for UK premium listed issuers, pension funds and asset managers, which many in the market consider as a more pragmatic and achievable approach. However, where a UK AIFM markets funds into the EU, the EU Disclosure Regulation may apply.

Specific requirements include:

(a) disclosures at entity level

Financial market participants and financial advisers must publish information about their policies on the integration of sustainability risks in their investment or insurance decision making process or investment or insurance advisory processes (article 3).

Financial market participants and financial advisers must include in their remuneration policies information on how those policies are consistent with the integration of sustainability risks and must publish a summary on their websites (article 5).

Financial market participants and financial advisers must publish and maintain where they consider principal adverse impact of investment decisions, investment advice or insurance advice on sustainability factors, a statement on due diligence policies with respect to those impacts or where they do not consider adverse impacts of investment decisions, investment advice or insurance advice on sustainability factors, clear reasons why. The "explain" statement is not available to financial market participants with over 500 employees or who are large group entities.

(b) disclosures at product level (articles 6 and 7)

Financial market participants and financial advisers must include in pre-contractual documentation a description of the manner in which sustainability risk is integrated into investment decisions, investment advice or insurance advice and assessment of likely impact on the returns of the product or an explanation why sustainability risks are not relevant.

(c) disclosures for "green" products (articles 8, 9, 10 and 11)

Where a financial product promotes, among other characteristics, environmental or social characteristics (and investments follow good governance practices), the financial market participant/financial adviser must disclose certain prescribed information.

- (i) on how those characteristics are met and
- (ii) on any index designated as a reference benchmark.

Where a financial product has sustainable investment as its objective, the financial market participant/financial adviser must disclose certain prescribed information depending on whether or not an index has been designated as a reference benchmark.

Where a financial product has a reduction in carbon emissions as its objective, the financial market participant/financial adviser must disclose certain prescribed information in relation to the Paris Agreement.

These disclosures will be incorporated into pre-contractual disclosures; disclosures on websites and disclosures in periodic reports in relation to such financial products.

On 04 February the Joint Committee of the three European Supervisory Authorities (the EBA, EIOPA and ESMA) delivered their final report to the European Commission setting out the RTS on the content, methodologies and presentation of disclosures under the SFDR (the “Final Report”).

The Final Report can be found [here](#).

The key points to note are:

- The proposed application date of the Final Report is 01 January 2022;
- The range of mandatory principal adverse impact indicators has been dramatically cut making this requirement less onerous for financial market participants; and
- New, much more visual, templates for periodic and pre-contractual disclosures have been produced for products within the scope of Article 8 (products with environmental or social characteristics) and Article 9 (products with sustainable investment objectives).

IMPACT - BUY SIDE

Fund managers who are established in the EU or who market their funds into the EU will be required to comply with these disclosure obligations, irrespective of whether they take into account ESG factors in their processes or whether they have “green” products.

Disclosure ESG funds: Fund managers who have article 8 (funds which promote environmental or social characteristics) or article 9 (pursues sustainable objectives) funds under the Disclosure Regulation will have to make additional disclosures both at entity and product level.

Disclosure non-ESG funds: Fund managers who do not have any article 8 or article 9 products (i.e. ESG products) will still have to make relevant disclosures at entity and product level (under Articles 3, 4, 5 and 6 respectively).

Delegation Agreements: for fund managers who manage third party funds, there will need to be relevant contractual arrangements to ensure the appropriate data flow from underlying issuers so that the fund manager can comply with requirement.

The data required under the Disclosure Regulation is different to the data required under the Taxonomy Regulation and is wider in scope (including governance and social issues, rather than just environmental). This means that the requirements of the Disclosure Regulation will need to be operationalised into relevant processes so that the data can be gathered from relevant investee companies or holdings to ensure that relevant disclosures can be made at entity level.

IMPACT - SELL SIDE

EU investment firms, insurers or credit institutions who undertake portfolio management and/or provide investment /insurance advice will be required to comply with these disclosure regulations, irrespective of whether they take into account ESG factors in their processes or whether they have ‘green’ products as described for the buy-side.

We expect sell side issuance to comply voluntarily with Taxonomy Regulation/Disclosure Regulation given buy side may request this (to comply with their own Disclosure Regulation/Taxonomy Regulation requirements).

ISSUES TO BE CONSIDERED FURTHER

The European Commission has said that while the requirement to comply with the Disclosure Regulation would still begin on March 10, 2021, as originally intended, firms would have to “comply with its high level and principle-based requirements”. Complying with the rule’s more detailed provisions has been delayed. “in order to provide financial market participants and financial advisers as well as supervisors with time for implementation, the Regulatory Technical Standards will become applicable at a later stage,”.

In addition, on 7 January 2021, the European Supervisory Authorities (EBA, ESMA, EIOPA) wrote a letter to the European Commission highlighting several important areas of uncertainty in the interpretation of the Disclosure Regulation. The letter notes that while many uncertainties may be clarified in due course the ESAs have identified certain priority questions that would benefit from “urgent clarification” in advance of the SFDR applying from 10 March 2021. The areas of uncertainty of priority are:

- the application of the SFDR to non-EU AIFMs and registered AIFMs;
- the application of the 500 employee threshold for principal adverse impact reporting on parent undertakings of a large group;
- the meaning of “promotion” in the context of (article 8) products promoting environmental or social characteristics;
- the application of article 9 SFDR; and
- the application of SFDR product rules to portfolios and dedicated funds.

We await a response from the European Commission on these issues.

DEFINITIONS

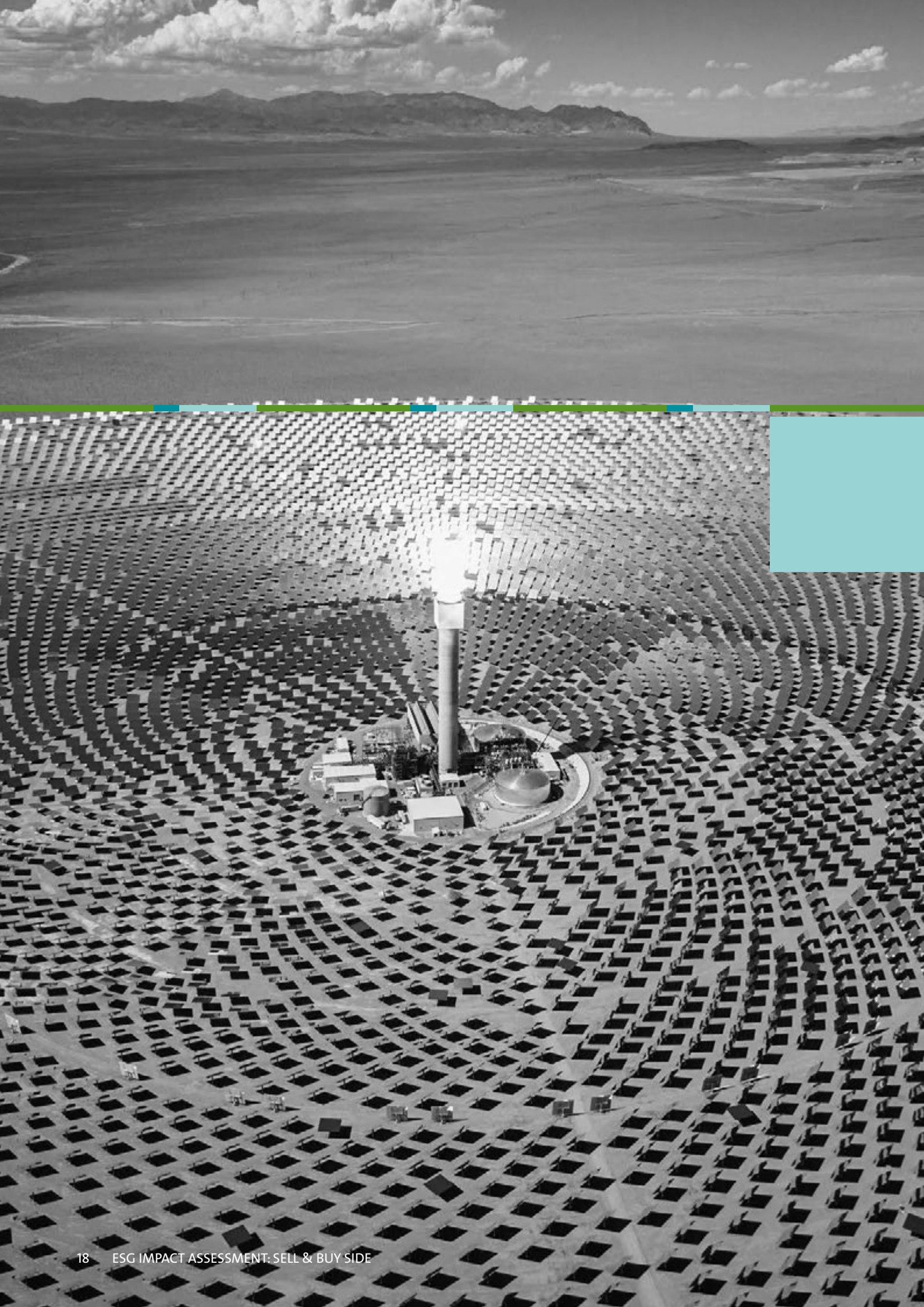
“Financial market participant” means:

- EU investment firm providing portfolio management;
- EU credit institution providing portfolio management;
- Fund managers (AIFMs);
 - AIF managers in the EU or marketing funds into the EU;
 - EuVECA / EuSEF managers;
- EU UCITS management company;
- Insurance undertaking / intermediary which makes available insurance based investment products (to retail and/or professional investors);
- Pension provider i.e. manufacturers and PEPP providers; and
- Institutions for occupational retirement provision.

“Financial advisers” means credit institutions providing investment advice; AIFMs providing investment advice in accordance with AIFMD; investment firms providing investment advice; UCITS management companies providing investment advice in accordance with the UCITS Directive; insurance intermediaries or insurance undertakings providing insurance advice in relation to Insurance Based Investment Products (IBIPs).

A **“sustainability risk”** means an environmental, social or governance event or condition that, if it occurs, could cause a negative material impact on the value of the investment.

A **“sustainability factor”** means environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.



EU TIMELINE

There is a staggered application of provisions under the Disclosure Regulation from 10 March 2021 until 31 December 2022.

Level 2 draft measures were published on 23 April 2020 and more are expected throughout next year.

As noted above, the application of the Level 2 measures has been delayed, although firms will have to comply with the Level 1 text on a high level basis, which may increase the regulatory burden.

UK TIMELINE

The UK has indicated that it will not onshore the Disclosure Regulation (which is within its right to do so as the substantive provisions are not operative prior to 31 December 2020). The UK has revoked provisions that were applicable before the end of the Transition Period via the Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020.

With respect to ESG disclosures, the UK has chosen to take a different approach to the EU and will consult on proposals for mandating Task Force on Climate-related Financial Disclosures (TCFD) to a large population of financial services firms, including pension funds and asset managers.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
As originally published Consolidated version	Draft consultation	N/A

OVERLAP WITH OTHER ESG REGULATIONS

The Taxonomy Regulation amended the Disclosure Regulation to include additional obligations on firms. There is also an overlap with the Low Carbon Benchmark Regulation in particular where a product promotes an environmental and/or social characteristic or pursues a sustainable objective and will need to disclose the relevant benchmark against which performance is measured.

Amendments to Low Carbon Benchmarks Regulation

THE PURPOSE OF THIS REGULATION IS TO INTRODUCE REFORMS TO THE EUROPEAN BENCHMARK REGULATION TO INTRODUCE TWO NEW TYPES OF BENCHMARK WHICH WILL HELP FIRMS MEASURE PERFORMANCE OF A FINANCIAL PRODUCT AGAINST THE PARIS AGREEMENT CLIMATE TARGETS.



WHAT IS IT?

The TEG suggested minimum standards for EU climate benchmarks to address the risk of greenwashing. [The Low Carbon Benchmarks Regulation](#) (EU 2019/2089) (the “**Amending Regulation**”) amends [The Benchmarks Regulation](#) (EU 2016/1011) (the “**BMR**”). The two key changes relevant to ESG are detailed below.

Establishes two climate benchmarks

- The Amending Regulation introduces two new types of climate benchmarks:

AN EU CLIMATE TRANSITION BENCHMARK	AN EU PARIS-ALIGNED BENCHMARK
<ul style="list-style-type: none">• The EU Climate Transition Benchmark (“CTB”) is a “low carbon benchmark”.• The CTB selects, weights or excludes underlying assets to set the resulting benchmark portfolio on a decarbonisation trajectory in light of the long-term global warming target set out in the Paris Climate Agreement.	<ul style="list-style-type: none">• The EU Paris-aligned benchmark (“PAB”) is a “positive carbon benchmark”.• The PAB selects, weights or excludes underlying assets in a way that the resulting benchmark’s portfolio’s carbon emissions are aligned with the 2C temperature reduction target set out in the Paris Climate Agreement and do not significantly harm other ESG objectives .

- The European Commission has adopted a Delegated Regulation (2020/1818) specifying rules governing choice of underlying assets, method for weighting underlying assets and the determination of the decarbonisation trajectory for CTBs.

Introduces sustainability related disclosure requirements for benchmarks

- The Amending Regulation mandates that administrators of benchmarks or families of benchmarks must provide certain disclosures (except for interest rate and currency benchmarks):
 - Benchmark statement disclosures: A high-level explanation in the benchmark statement of how ESG factors and the objectives of the Paris Climate Agreement are reflected in the methodology for each benchmark or family of benchmarks.
 - Methodology disclosures: A more detailed explanation in the benchmark methodology of how ESG factors are reflected in the benchmark’s characteristics including rationale for adopting the methodology, criteria and procedures used to determine the benchmark and the identification of potential limitations.
- The European Commission has adopted Delegated Regulations (2020/1816 and 2020/1817) specifying rules governing the minimum content and format of the explanations.

WHO DOES IT APPLY TO?

The Amending Regulation applies in respect of the following within the EU:

- The provision of benchmarks (i.e. benchmark administrators);
- The contribution of input data to a benchmark (i.e. benchmark contributors);
- The use of a benchmark (i.e. benchmark users).

IMPACT - BUY SIDE

Asset managers should consider whether any of their funds have sustainable investment as their objective and, if so, whether their choice of benchmarks aligns with the sustainable objectives of the fund. This may include considering whether a PAB and/or CTB ought to be used to measure performance particularly where the objective of the fund is reduction in carbon emissions.

IMPACT - SELL SIDE

Sell side firms who administer benchmarks should ensure that their benchmark statements and benchmark methodologies have relevant ESG disclosure annexes.

ISSUES TO BE CONSIDERED FURTHER

ESMA issued a [press release](#) on 29 April 2020 stating that it considers it necessary for national competent authorities to address the absence of delegated regulations through consistent risk-based supervisory and enforcement practices.

Related to this, ESMA published a [no action letter](#) on 29 April 2020 addressed to national competent authorities stating that they should not prioritize any supervisory or enforcement action in relation to the new requirements until delegated regulations apply.

However, the European Commission updated its [webpage](#) on 17 July 2020 to announce the adoption of the Delegated Regulations (2020/1816, 2020/1817 and 2020/1818) on sustainable finance issues. These were published in the Official Journal on 3 December 2020 and came into force on 23 December 2020.

DEFINITIONS

See explanations of the “CTB” and “PAB” benchmarks above.

“Low Carbon Benchmark” is not defined in the Amending Regulation. However, it effectively means a benchmark where the underlying assets are selected so that the resulting benchmark portfolio has less carbon emissions.

“Positive Carbon Benchmark” is not defined in the Amending Regulation. However, it effectively means a benchmark where the underlying assets are selected on the basis that their carbon emissions savings exceed the asset’s carbon footprint.

EU TIMELINE

The Amending Regulation entered into force on 10 December 2019, but the deadline for compliance varies depending on the obligation:

- Climate benchmarks: comply with minimum standards of climate benchmarks by 30 April 2020;
- Benchmark statements: comply with disclosure requirements on ESG factors by 30 April 2020 and disclosure requirements on alignment with objectives under Paris Climate Agreement by 31 December 2021;
- Methodology disclosures: comply with disclosure requirements on methodology by 30 April 2020.

The Delegated Acts were published in the Official Journal on 3 December 2020 and came into force on 23 December 2020.

UK TIMELINE

As the Amending Regulation and Delegated Regulations became applicable before the end of the Brexit transition period on 31 December 2020, they were onshored into English law as part of the broader onshoring process.

The Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020 (SI 2020/628) incorporates the provisions of the Amending Regulation.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
The Amending Regulation	Delegated Regulation 2020/1816 Delegated Regulation 2020/1817 Delegated Regulation 2020/1818	N/A

OVERLAP WITH OTHER ESG REGULATIONS

The Disclosure Regulation mandates pre-contractual disclosures and periodic reports on the relevant choice of benchmark, i.e. the PAB or CTB, used in a financial product which promotes ESG characteristics or promotes sustainable objectives.



EU Green Bond Standard

THE PURPOSE OF THIS STANDARD IS TO ENHANCE THE EFFECTIVENESS, TRANSPARENCY, COMPARABILITY AND CREDIBILITY OF THE GREEN BOND MARKET AND TO ENCOURAGE MARKET PARTICIPANTS TO ISSUE AND INVEST IN EU GREEN BONDS.

WHAT IS IT?

The TEG proposed a voluntary, non-legislative EU Green Bond Standard (“EU GBS”) in order to create a set of uniform requirements in the EU. On 18 June 2019, the TEG published a [final report](#) on the EU GBS which contains principles and a draft model of the EU GBS. On 9 March 2020, the TEG also published a [usability guide](#) which contains recommendations on the practical application of the EU GBS and is intended to assist potential issuers, verifiers and investors of EU green bonds.

Proposed core components of an EU Green Bond Standard:

- **Alignment with EU-taxonomy:** Proceeds from EU Green Bonds should go to finance or refinance projects/activities that (a) contribute substantially to at least one of the six taxonomy Environmental Objectives, (b) do not significantly harm any of the other Objectives and (c) comply with the minimum social safeguards. Where technical screening criteria have been developed, financed projects or activities shall meet these criteria, allowing however for specific cases where these may not be directly applicable.
- **Publication of a Green Bond Framework:** The Green Bond Framework should confirm the voluntary alignment of green bonds issued with the EU GBS, explain how the issuer’s strategy aligns with the Environmental Objectives, and provide details on the process for selection of Green Projects, management of use of proceeds from such projects and information on publication of green bond reports. A template for Green Bond Framework is provided.
- **Mandatory reporting:** Mandatory reporting on use of proceeds (allocation report) and on environmental impact (impact report). A template for the reporting is provided.

ALLOCATION REPORT	IMPACT REPORT HTTPS://BIT.LY/2ZH7T6M
<ul style="list-style-type: none"> • Allocation reporting should be published at least on an annual basis until full allocation of bond proceeds to Green Projects and thereafter in case of material changes in this allocation. • A statement of alignment with EU Green Bond Standard. • A breakdown of allocated amounts to Green Projects on sector level at a minimum. • A breakdown of regional distribution of Green Projects recommended on country level. 	<ul style="list-style-type: none"> • Impact reporting should be published at least once during the bond lifetime after full allocation of bond proceeds to Green Projects and thereafter in case of material changes in this allocation. • A description of Green Projects and the Environmental Objective pursued in respect of them. • A breakdown of Green Projects by what is being financed and the share of financing and refinancing. • Information and metrics if possible about the Green Projects’ environmental impacts which needs to be in line with commitment and methodology described in the Green Bond Framework. • Information on methodology and assumptions used to evaluate the Green Projects impacts if not already detailed in Green Bond Framework.

- **Mandatory verification:** Mandatory verification of (a) the Green Bond Framework before or at the time of issuance and (b) allocation report after full allocation of proceeds, by an accredited external reviewer. Optional verification of the impact report would be encouraged.
- **External reviewers:** The TEG recommends that external verifiers are formally accredited and supervised. It believes the most suitable authority for this would be ESMA. As this will take time, it suggests an interim registration process for external reviewers of green bonds, for a transition period of up to 3 years. A list of current external reviewers in Europe is provided.



Additional incentives to support the EU Green Bond market

The TEG proposed six additional incentives suggesting how the European Commission, EU Member State governments and market participants can support the uptake of the EU Green Bond Standard through both demand and supply side measures.

WHO DOES IT APPLY TO?

Bond issuers who decide to voluntarily adopt the EU Green Bond Standard.

IMPACT - BUY SIDE

Consider whether any of funds have underlying assets which comply with the EU Green Bond Standard, and if so, whether the relevant disclosures have been brought to the attention of investors.

IMPACT - SELL SIDE

Consider adopting the EU Green Bond Standard once finalised when issuing Green Bonds. However, this will largely be driven by what the market decides as whole.

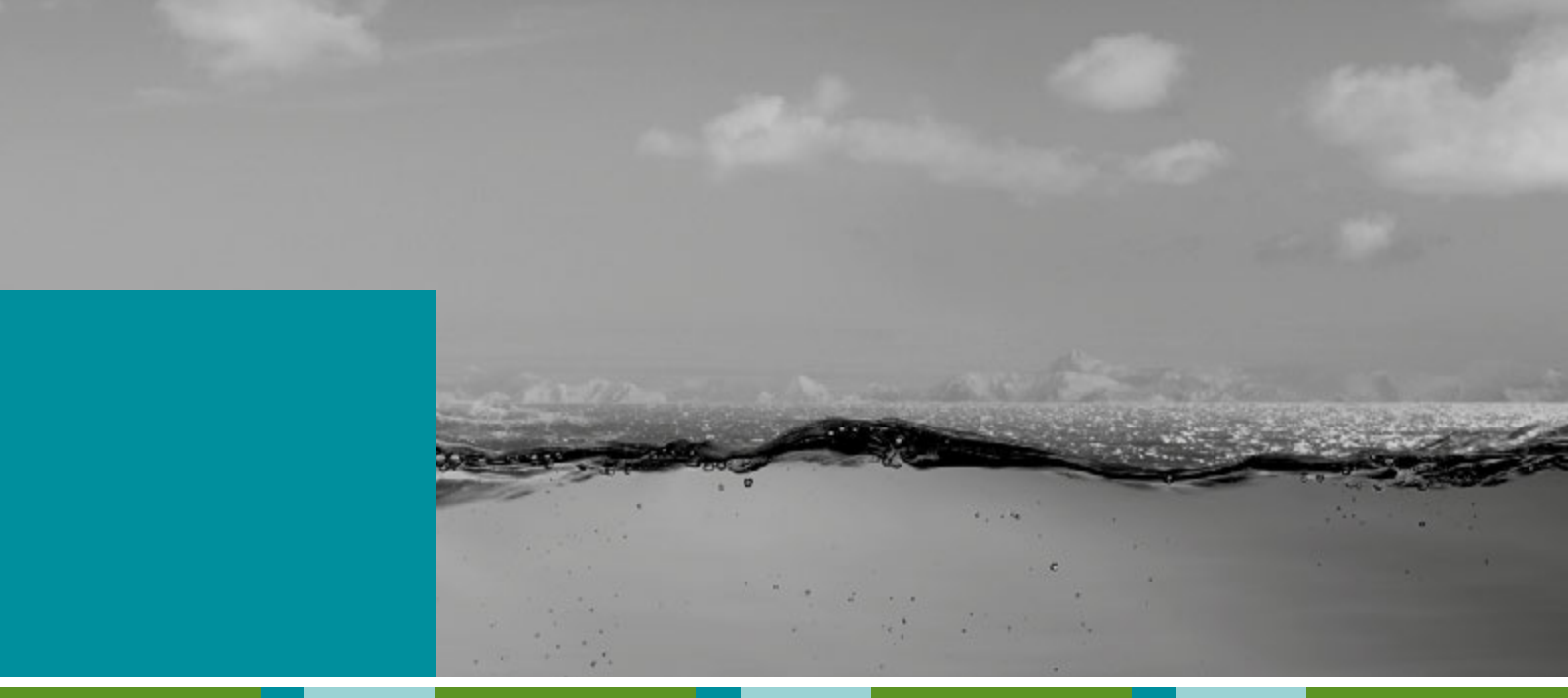
ISSUES TO BE CONSIDERED FURTHER

The [ICMA Green Bond Principles](#), promulgated by ICMA in 2014, are available for market participants to utilize. Based on a use of proceeds approach, the GBP suggest but do not mandate third party verification and are agnostic as to taxonomy.

DEFINITIONS

“EU Green Bond” means any type of listed or unlisted bond or capital market debt instrument issued by a European or international issuer that is aligned with the EU GBS.

“Green Projects” means those projects aligned with the requirements set out in the Taxonomy Regulation.



TIMELINES

The European Commission is exploring the possibility of a legislative initiative for an EU Green Bond Standard in the context of (i) a public [consultation](#) on the renewed sustainable finance strategy, taking place from 6 April to 15 July 2020, and (ii) a targeted [consultation](#) on the establishment of an EU GBS, taking place from 12 June and 2 October 2020. Based on the outcome of these two consultations (which are now closed) as well as ongoing bilateral stakeholder dialogues the European Commission will take a decision on next steps and the role the EU GBS will play in delivering a sustainable finance framework for the EU.

SOURCES

[Final Report on EU Green Bond Standard, 18 June 2019](#)

[Usability Guide for EU Green Bond Standard, 9 March 2020](#)

[Consultation on the renewed sustainable finance strategy, 6 April – 15 July 2020](#)

[Targeted consultation on the establishment of an EU Green Bond Standard, 12 June – 2 October 2020](#)

OVERLAP WITH OTHER ESG REGULATIONS

The Taxonomy Regulation.

Amendments to MiFID II

REQUIRING FIRMS TO CONSIDER CLIENTS'
ENVIRONMENTAL OBJECTIVES WITHIN
SUITABILITY TESTS.

WHAT IS IT?

MiFID II has been amended to take into account sustainability through the following: (a) Proposed Delegated Regulation amending Commission Delegated Regulation (EU) 2017/565 (“**MiFID Org Regulation**”) as regards the integration of ESG considerations and preferences into the investment advice and portfolio management; and (b) Proposed Delegated Directive amending Commission Delegated Regulation (EU) 2017/593 as regards the integration of sustainability factors and preferences into the product governance obligations (“**MiFID Delegated Directive**”).

Investment firms will be required to take into account ESG considerations when complying with organisational requirements, product governance and suitability assessments.

WHO DOES IT APPLY TO?

All EU investment firms which are subject to **MiFID II**

The changes have not been onshored to the UK, and therefore UK firms should monitor for further statements from UK authorities. However, there is currently a market expectation that UK authorities will implement similar changes to each regime in due course.

IMPACT - BUY SIDE

- Update suitability assessments and reports for sustainability; and
 - Update product governance for sustainability;
- For both of the above, more information will be required to be provided by clients.
- Update organisational policies and procedures, conflicts of interest and remuneration policies; and
 - Update risk management policies and framework for sustainability risks.

IMPACT - SELL SIDE

- Update product governance policies and procedures;
- Update organisational policies and procedures, conflicts of interest and remuneration policies;
- Where the sell side is providing advice, update suitability policies and reports; and
- Update risk management policies and framework for sustainability risks.

ISSUES TO BE CONSIDERED FURTHER

The Taxonomy Regulation is important in understanding the impact of changes to the MiFID Org Regulation, as there is direct link between the sustainability preferences investors are able to specify and what will be considered to be an “environmentally sustainable investment”, “social investment” or “good governance investment”.

DEFINITIONS

“**Sustainability preferences**” means a client’s or potential client’s choice as to whether either of the following financial instruments should be integrated into his or her investment strategy.

“**Sustainability factors**” means sustainability factors as defined in Article 2(24) of the Disclosure Regulation.

EU TIMELINE

July 2018 – the European Commission sought advice from ESMA on the potential to integrate sustainability considerations into EU Directives governing investment firms.

December 2018 – ESMA Consultation Paper on the draft technical advice on integrating of sustainability risks and factors in MiFID II (ESMA35-43-1210).

January 2019 - the Draft Delegated Regulation was published.

April 2019 – ESMA Final Report and technical advice to the EC on the above (ESMA35-43-1737).

June 2020 – A draft directive amending Delegated Directive (EU) 2017/593) and a draft Regulation amending Delegated Regulation (EU) 2017/565 were published but have not been formally adopted. The Regulation is stated to apply 12 months after publication in the Official Journal and the Directive must be transposed 12 months after entry into force (20 days after publication in the Official Journal).

UK TIMELINE

The changes have not been onshored to the UK, and therefore UK firms should monitor for further statements from UK authorities. We expect UK authorities to implement similar changes to each regime in due course.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
MiFID II	MiFID Org Regulation, as amended by the proposed Commission Delegated Regulation MiFID Delegated Directive as amended by the proposed Commission Delegated Regulation	ESMA Final Report and technical advice to the EC on the above (ESMA35-43-1737)

OVERLAP WITH OTHER ESG REGULATIONS

The ESG Taxonomy Regulation, which contains key definitions, as does the SFDR.

Amendments to MiFID II

ANNEX A

1. ORGANISATION REQUIREMENTS

The MiFID Org Regulation does not explicitly require the integration of ESG considerations within an investment firm's organisational requirements. Such integration should follow a principles-based approach similar to that already followed for other relevant risks (e.g. interest rate or credit risk). The proposed amendments to the MiFID Org Regulation are:

(a) Scope and definitions – the following is added to Article 1:

“(7) ‘sustainability preferences’ means a client’s or potential client’s choice as to whether either of the following financial instruments should be integrated into his or her investment strategy:

- (a) a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council*;*
- (b) a financial instrument that promotes environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088 and that either:*
 - (i) pursues, among others, sustainable investments as defined in Article 2, point (17), of that Regulation; or*
 - (ii) as of 30 December 2022, considers principal adverse impacts on sustainability factors, as referred to in Article 7(1), point (a), of that Regulation;*

(8) ‘sustainability factors’ means sustainability factors as defined in Article 2, point (24), of Regulation (EU) 2019/2088;

(9) ‘sustainability risks’ means sustainability risks as defined in Article 2, point (22), of Regulation (EU) 2019/2088

(b) General organisation requirements – the following language will be added to Article 21(1):

“Investment firms shall comply with the following organisational requirements:

[...]

Investment firms shall take into account sustainability risks when complying with the requirements set out in this paragraph

When complying with the requirements set out in this paragraph, investment firms shall take into account the nature, scale and complexity of the business of the firm, and the nature and range of investment services and activities undertaken in the course of that business.”

(c) Risk management policies - the following language will be added to Article 23(1)(a):

“establish, implement and maintain adequate risk management policies and procedures which identify the risks relating to the firm’s activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm. In doing so, investment firms shall take into account sustainability risk.”

(d) Conflicts of interests – the following language is in Recital 4 (bis):

When identifying the types of conflicts of interest the existence of which may damage the interests of a client, include those types of conflicts of interest that stem from the distribution of sustainable investments or from investments that promote environmental or social characteristic.

Article 52: information about investment advice – the following information is added:

3. Investment firms shall provide a description of:

- (a) the types of financial instruments considered;*
- (b) the range of financial instruments and providers, analysed per each type of instrument according to the scope of the service;*
- (c) when providing independent advice, how the service provided satisfies the conditions for the provision of investment advice on an independent basis;*
- (d) the factors taken into consideration in the selection*

process used by the investment firm to recommend financial instruments, including risks, costs and complexity of the financial instruments, including any sustainability factors

Article 54: assessment of suitability and suitability factors is amended as follows:

- (a) in paragraph 2, point (a) is replaced by the following:
“(a) it meets the investment objectives of the client in question, including the client’s risk tolerance and any sustainability preferences;”;
- (b) paragraph 5 is replaced by the following:
“5. The information about the investment objectives of the client or potential client shall include, where relevant, information about the length of time for which the client wishes to hold the investment, his or her preferences regarding risk taking, his or her risk tolerance, the purpose of the investment and his or her sustainability preferences, if any.”;
- (c) paragraph 9 is replaced by the following:
“9. Investment firms shall have in place, and be able to demonstrate that they have in place, adequate policies and procedures to ensure that they understand the nature, features, including costs, risks of investment services, and financial instruments selected for their clients, including any sustainability factors, and that they shall assess, while taking into account cost and complexity, whether equivalent investment services or financial instruments can meet their client’s profile.”;
- (d) in paragraph 12, the first subparagraph is replaced by the following:
“12. When providing investment advice, investment firms shall provide a report to the retail client that includes an outline of the advice given and explains how the recommendation provided is suitable for the retail client, including how the recommendation meets the client’s investment objectives, his or her personal circumstances with reference to the investment term required, the client’s knowledge and experience, the client’s attitude to risk, his or her capacity to sustain losses and his or her sustainability preferences.”;

2. PRODUCT GOVERNANCE

The conditions to identify a target market under the MiFID Delegated Directive do not explicitly establish the details of the integration of sustainability factors by investment firms manufacturing financial instruments and their distributors and insurance undertakings, intermediaries manufacturing insurance products for sale to customers and insurance distributors. Such integration should ensure a proper degree of consideration of relevant/material sustainability considerations, but sustainability considerations should not be given precedence over a client’s personal investment objectives. The proposed amendments to the MiFID Delegated Directive are:

(a) Scope and definitions – the following language has been added to Article 1

“5. ‘sustainability preferences’ means a client’s or potential client’s choice as to whether either of the following financial instruments should be integrated into his or her investment strategy:

a financial instrument that has as its objective sustainable investments as defined in Article 2, point (17), of Regulation (EU) 2019/2088 of the European Parliament and of the Council;*

a financial instrument that promotes environmental or social characteristics as referred to in Article 8 of Regulation (EU) 2019/2088 and that either:

- (i) pursues, among others, sustainable investments as defined in Article 2, point (17), of that Regulation; or*
- (ii) as of 30 December 2022, considers principal adverse impacts on sustainability factors, as referred to in Article 7(1), point (a), of that Regulation;*

6. ‘sustainability factors’ means sustainability factors as defined in Article 2, point (24), of Regulation (EU) 2019/2088

(b) Identification of target markets – the following language will be added to Article 9(9) of the MiFID Delegated Directive:

“Member States shall require investment firms to identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whose needs, characteristics and objectives, including any sustainability preferences, the financial instrument is compatible. As part of this process, the firm shall identify any group(s) of clients for whose needs, characteristics and objectives the financial instrument is not compatible. Where investment firms collaborate to manufacture a financial instrument, only one target market needs to be identified.”

(c) Integration of sustainability factors into suitability determination – the following language will be added to Article 9(11) of the MiFID Delegated Directive:

“Member States shall require investment firms to determine whether a financial instrument meets the identified needs, characteristics and objectives of the target market, including by examining the following elements:

- (a) the financial instrument’s risk/reward profile is consistent with the target market; and*
- (b) financial instrument’s sustainability factors are consistent with the target market; and*
- (c) the financial instrument design is driven by features that benefit the client and not by a business model that relies on poor client outcomes to be profitable.”*

(d) Integration of sustainability preferences - the following language will be added to Article 9(14) of the MiFID Delegated Directive:

“Member States shall require investment firms to review the financial instruments they manufacture on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Investment firms shall consider if the financial instrument remains consistent with the needs, characteristics and objectives, including any sustainability preferences, of the target market and if it is being distributed to the target market, or is reaches clients for whose needs, characteristics and objectives the financial instrument is not compatible.”

(e) Integration of sustainability preferences into distribution strategy – the following language will be added to Article 10(2) or the MiFID Delegated Directive:

“Member States shall require investment firms to have in place adequate product governance arrangements to ensure that products and services they intend to offer or recommend are compatible with the needs, characteristics, and objectives, including any sustainability preferences of an identified target market and that the intended distribution strategy is consistent with the identified target market. Investment firms shall appropriately identify and assess the circumstances and needs of the clients they intend to focus on, so as to ensure that clients’ interests are not compromised as a result of commercial or funding pressures. As part of this process, investment firms shall identify any group of clients for whose needs, characteristics and objectives the product or service is not compatible”

(f) Integration of sustainability preferences into ongoing assessment of distribution strategy – the following language will be added to Article 10(5) of the MiFID Delegated Directive:

“Member States shall require investment firms to review the investment products they offer or recommend and the services they provide on a regular basis, taking into account any event that could materially affect the potential risk to the identified target market. Firms shall assess at least whether the product or service remains consistent with the needs, characteristics and objectives, including any sustainability preferences, of the identified target market and whether the intended distribution strategy remains appropriate. Firms shall reconsider the target market and/or update the product governance arrangements if they become aware that they have wrongly identified the target market for a specific product or service or that the product or service no longer meets the circumstances of the identified target market, such as where the product becomes illiquid or very volatile due to market changes.”

Amendments to AIFMD

INTEGRATION OF SUSTAINABILITY
RISKS AND FACTORS IN THE INTERNAL
PROCESSES AND PROCEDURES OF
ALTERNATIVE INVESTMENT FUND
MANAGERS (AIFMS).

WHAT IS IT?

Following a formal request from the European Commission and a consultation process, in April 2019 ESMA published its technical guidance on proposed amendments to AIFMD to explicitly require authorised fund managers (“AIFs”) to evaluate the sustainability risks of their investments, similar to that already followed for other relevant risks (e.g. interest rate or credit risk), and integrate sustainability considerations into the processes and procedures.

The ESMA technical advice is translated into amendments to Level 2 provisions in Commission Delegated Regulation (EU) 231/2013 (“**AIFM Delegated Act**”). Annex A sets out the proposed amendments in more detail.

The proposed amendments relate to:

- (a) **organisational procedures** – incorporation of sustainability risks within organisational procedures, systems, and controls to ensure that they are properly taken into account in investment and risk management processes (e.g. decision making, internal reporting, and monitoring);
- (b) **resources** – ensuring there are required resources and expertise for the “effective integration of sustainability risks” into the governance structure. This would need to be considered in light of the general obligation on AIFMs to employ personnel with skill, knowledge, and expertise to discharge their responsibilities;
- (c) **senior management responsibilities** – the integration of sustainability risk is part of the collective responsibility of senior management;

WHO DOES IT APPLY TO?

EU AIFMs (excluding sub-threshold EU AIFMs).

The changes have not been onshored to the UK, and therefore UK firms should monitor for further statements from UK authorities. However, there is currently a market expectation that UK authorities will implement similar changes in due course.

- (d) **conflicts of interest** – consideration of the types of conflicts of interest arising in relation to the integration of sustainability risks and factors. Greenwashing, mis-selling and misrepresentation of investment strategies are all potential sources of “sustainability” conflicts;
- (e) **due diligence requirements** – AIFMs are already subject to due diligence requirements relating to the selection and ongoing monitoring of investments. Going forward, AIFMs will need to consider sustainability risks when selecting and monitoring investments, designing written policies and procedures on due diligence and implementing effective arrangements (and where AIFMs consider the principal adverse impacts of investment decisions on sustainability factors as set out in SFDR, AIFMs will need to take into account principal adverse impacts when complying with due diligence requirements in the Delegated Regulation);
- (f) **risk management** – explicit inclusion of sustainability risks when establishing, implementing and maintaining an adequate and documented risk management policy; and
- (g) **general requirements** - AIFMs will take into account sustainability risks when complying with general requirements.

As sustainability risks are not relevant in the same way for all investment portfolios /strategies, proportionality applies.

IMPACT - BUY SIDE

- Consideration of sustainability risk applies regardless of the investment strategy, in a proportionate manner, e.g. applies differently to hedge funds / algorithmic trading strategies versus PE managers.
- Relevant employees will need to understand the sustainability risks relevant to their investment strategy.
- Senior management to have a good understanding of the firm's policy in relation to sustainability issues, and receives the necessary MI.
- Update conflicts of interest policy.
- Update new product and activity approval procedures, to include ESG assessments, and preventing products being mislabelled as "green".
- AIFMs to engage more actively directly, or via an intermediary, with issuers to ensure that fundraisings are not mislabelled as "green".
- AIFMs will be required to develop engagement strategies with investee companies, e.g. through voting strategies to address material sustainability risks and achieve more sustainable outcomes.

IMPACT - SELL SIDE

N/A



ISSUES TO BE CONSIDERED FURTHER

- (1) Whether the EU AIFM will appoint a qualified person in charge of the integration of sustainability risks and the consideration of adverse impacts of investment decisions on sustainability factors, e.g. a “Chief Sustainability Officer”.
- (2) Linked to the above, how will AIFMs comply with the AIFMD reforms in light of SMCR, and in particular its senior manager and certification staff population?
- (3) No definition of “investee company” or any shareholding threshold beyond which firms will need to begin engaging around ESG issues.
- (4) The reforms will not apply to sub-threshold AIFMs. However, note that some Member States have gold-plated AIFMD (e.g. Germany) and may decide to also gold-plate the reforms. Developments to be monitored.
- (5) EU AIFMs are subject to the updated due diligence requirements and conflicts of interest considerations, but there are no equivalent requirements for authorised entities providing individual portfolio management pursuant to Article 6(4) (a) of the AIFMD.

The Commission may consider additional legislative amendments to ensuring a level playing field between collective and individual portfolio management. Developments to be monitored.

- (6) The reforms will not apply directly to non-EU AIFMs (even where the non-EU AIFM is marketing to EU investors) unless a Member State gold-plates the rules. Developments to be monitored.

However, where non-EU entity act as sub-manager or sub-advisor to an EU AIFM, the EU AIFM will likely seek to require the non-EU entity to adhere to some of the new requirements when performing its portfolio management responsibilities (e.g. in relation to investment due diligence).

DEFINITIONS

“Sustainability risk” is not defined in the amendments to AIFMD. It is defined in the Disclosure Regulation as “an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact”.

“Sustainability factors” is not defined in the amendments to AIFMD. It is defined in the Disclosure Regulation as “environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters”.

EU TIMELINE

The European Commission sought advice from ESMA on the potential to integrate sustainability considerations into EU Directives governing fund managers in July 2018.

ESMA Consultation Paper on the draft technical advice on integrating of sustainability risks and factors in the UCITS Directive and AIFMD ([ESMA34-45-569](#)) was published in December 2018.

ESMA Final Report and technical advice to the EC on the above ([ESMA34-45-688](#)) was published on 30 April 2019.

In June 2020, the European Commission published a delegated act following ESMA's advice. This has not yet been published in the Official Journal. The delegated act is scheduled to apply 1 year after publication in the Official Journal.

UK TIMELINE

The changes have not been onshored to the UK, and therefore UK firms should monitor for further statements from UK authorities. We expect UK authorities to implement similar changes to each regime in due course.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
N/A	Amendments to Articles 22, 57 and 60 of Commission Delegated Regulation (EU) 231/2013	30 April 2019 – ESMA Final Report and technical advice to the EC on the above (ESMA34-45-688)

OVERLAP WITH OTHER ESG REGULATIONS

Taxonomy Regulation.

Disclosure Regulation.



Amendments to AIFMD

ANNEX A

3. ORGANISATION REQUIREMENTS

The AIFM Delegated Act does not explicitly require the integration of sustainability risks within an AIF's organisational requirements. Such integration should follow a principles-based approach similar to that already followed for other relevant risks (e.g. interest rate or credit risk). The proposed amendments to the AIFM Delegated Act are:

- (a) **General organisation procedures** – the following language will be added to Article 57(1):
"AIFMs shall take into account sustainability risks when complying with the requirements laid down in the first subparagraph."
- (b) **Resources** – the following language will be added to Article 22(3):
"For the purposes of paragraph 1, AIFMs should take into account the necessary resources and expertise for the effective integration of sustainability risks."
- (c) **Control by the governing body, senior management and supervisory function** – the following language will be added to Article 60(2):
"An AIFM shall ensure that its senior management: (i) is responsible for the integration of sustainability risk."

Article 52: **information about investment advice** – the following information is added:

4. AMENDMENTS TO OPERATING CONDITIONS

Organisation requirements in the AIFM Delegated Act, do not establish the details of the integration of sustainability risks within the conduct or business or prudent person rules and due diligence requirements.

- (a) **Conflicts of interests – the following language is in Recital 5:**
"when identifying the types of conflicts of interest the existence of which may damage the interests of an AIF, include conflicts of interest that may arise as a result of the integration of sustainability risks in their processes, systems and internal controls. Those conflicts may include conflicts arising from remuneration or personal transactions of relevant staff, conflicts of interest that could give rise to greenwashing, mis-selling or misrepresentation of investment strategies and conflicts of interests between different AIFs managed by the same AIFM"
- (b) **Due diligence requirements**
Managers should (i) define an investment strategy, (ii) where relevant, identify a proper asset allocation which clarifies how clients' money is allocated in accordance with the investment strategy, (iii) undertake proper due

diligence in the selection and monitoring of investments, and (iv) ensure that the portfolios remain in line with the investment strategy and, where relevant, the asset allocation, while integrating sustainability risks.

As sustainability risks are not relevant in the same way for each investment portfolio, the due diligence requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio.

In view of the above, the following language will be added to Article 18(5):

"AIFMs shall take into account sustainability risks and, where applicable, the principal adverse impact of investment decisions on sustainability factors when complying with the requirements set out in paragraphs 1 to 3."

"Where AIFMs consider principal adverse impacts of investment decisions on sustainability factors as described in Article 4(1), point (a) of Article 4 of Regulation (EU) 2019/2088, or as required by paragraphs 3 or 4 of Article 4 of that Regulation, those AIFMs shall take into account such principal adverse impacts when complying with the requirements set out in paragraphs 1 to 3 of this Article."

5. AMENDMENTS TO RISK MANAGEMENT

Risk assessments should consider both financial and relevant sustainability risks. The valuation processes should ensure a proper degree of consideration of relevant/material sustainability risks, but sustainability risk should not be given precedence over other types of risks.

A principles-based approach is the preferred solution as the risk management processes of funds need to be specifically tailored to their investment strategies, the characteristics of the portfolios and the objectives of the underlying investors.

In view of the above, the following language will be added to Article 40:

"(1) An AIFM shall establish, implement and maintain an adequate and documented risk management policy which identifies all the relevant risks to which the AIFs it manages are or may be exposed.

(2) The risk management policy shall comprise such procedures as are necessary to enable the AIFM to assess for each AIF it manages the exposure of that AIF to market, liquidity, sustainability and counterparty risks, and the exposure of the AIF to all other relevant risks, including operational risks, which may be material for each AIF it manages."

Amendments to UCITS

INTEGRATION OF SUSTAINABILITY
RISKS AND FACTORS IN THE INTERNAL
PROCESSES AND PROCEDURES OF UCITS
MANAGEMENT COMPANIES.

HYDROGEN H₂

WHAT IS IT?

Following a formal request from the European Commission and a consultation process, in April 2019 ESMA published its technical guidance on proposed amendments to AIFMD to explicitly require UCITS Management Companies (“**UCITS ManCos**”) to evaluate the sustainability risks of their investments, similar to that already followed for other relevant risks (e.g. interest rate or credit risk), and integrate sustainability considerations into the processes and procedures.

The proposed amendments for UCITS ManCos are near identical to those proposed for AIFMs. Please see section on “Amendments to AIFMD” for further details, substituting “AIFM” with “UCITS ManCo”.

The ESMA technical advice were translated into amendments to Level 2 provisions in Commission Directive 2010/43/EU (“**UCITS Delegated Act**”). Annex A sets out the proposed amendments in more detail.

WHO DOES IT APPLY TO?

UCITs ManCos

IMPACT - BUY SIDE

- The impacts of the proposed amendments on UCITS ManCos are near identical to the impacts on AIFMs.
- Please see section on “Amendments to AIFMD” for further details, substituting “AIFM” with “UCITS ManCo”.

IMPACT - SELL SIDE

- N/A

ISSUES TO BE CONSIDERED FURTHER

- (1) Whether the UCITS ManCo will appoint a qualified person in charge of the integration of sustainability risk and the consideration of adverse impacts of investment decisions on sustainability factors, e.g. a “Chief Sustainability Officer”.
- (2) The reforms will not apply directly to non-EU managers (even where the manager is marketing to EEA investors) unless Member States gold-plate the rules.
However, where non-EU entity act as sub-manager or sub-advisor to an UCITS ManCo, the UCITS ManCo will likely seek to require the non-EU entity to adhere to certain of the new requirements when performing its portfolio management responsibilities (e.g. in relation to investment due diligence).
- (3) UCITS ManCos are subject to the updated due diligence requirements and conflicts of interest considerations, but there are no equivalent requirements for authorised entities providing individual portfolio management pursuant to Article 6(3)(a) of the UCITS Directive.

The Commission may consider additional legislative amendments to ensure a level playing field between collective and individual portfolio management. Developments to be monitored.

DEFINITIONS

See section on “Amendments to AIFMD”.

EU TIMELINE

July 2018 – the European Commission sought advice from ESMA on the potential to integrate sustainability considerations into EU Directives governing fund managers.

December 2018 – ESMA Consultation Paper on the draft technical advice on integrating of sustainability risks and factors in the UCITS Directive and AIFMD ([ESMA34-45-569](#)).

April 2019 – ESMA Final Report and technical advice to the EC on the above ([ESMA34-45-688](#)).

June 2020 - a draft Delegated Directive amending Directive 2010/43/EU as regards the sustainability risks and sustainability factors to be taken into account for UCITS was published. It has not yet been formally adopted. The draft delegated Directive is stated to enter into force on the on the twentieth day following its publication in the Official Journal. The draft delegated Directive states that transposing measures will apply in EU member states from the first day of the twelfth month after publication in the Official Journal.

UK TIMELINE

The changes have not been onshored to the UK, and therefore UK firms should monitor for further statements from UK authorities. We expect UK authorities to implement similar changes to each regime in due course.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
N/A	Amendments to Articles 4, 5, and 9 of Commission Directive 2010/43/EU	30 April 2019 – ESMA Final Report and technical advice to the EC on the above (ESMA34-45-688)

OVERLAP WITH OTHER ESG REGULATIONS

Taxonomy Regulation.

Disclosure Regulation.

Amendments to UCITS

ANNEX A

1. ORGANISATION REQUIREMENTS

The UCITS Delegated Act does not explicitly require the integration of sustainability risks within a UCIT ManCo's organisational requirements. Such integration should follow a principles-based approach similar to that already followed for other relevant risks (e.g. interest rate or credit risk). The proposed amendments to the UCITS Delegate Act are:

(a) Definitions - the following will be added to Article 3

"11. 'sustainability risk' means sustainability risk as defined in Article 2, point (22), of Regulation (EU) 2019/2088 of the European Parliament and of the Council;*

12 'sustainability factors' means sustainability factors as defined in Article 2, point (24), of Regulation (EU) 2019/2088.

(b) General organisation procedures – the following language will be added to Article 4(2):

"Member states shall ensure that management companies take into account sustainability risks when complying with the requirements laid down in the first subparagraph."

(c) Resources – the following language will be added to Article 5(5):

"Member States shall ensure that for the purposes laid down in paragraphs 1, 2 and 3, management companies take into account the necessary resources and expertise for the effective integration of sustainability risks."

(d) New Article (5a) Obligation for investment companies to integrate sustainability risks in the management of UCITS is added: *Member States shall ensure that investment companies integrate sustainability risks in the management of UCITS, taking into account the nature, scale and complexity of the business of the investment companies.*

(e) Control by the governing body, senior management and supervisory function – the following language will be added to Article 9(2)(g): *"The management company shall ensure that its senior management: ... (g) is responsible for the integration of sustainability risk."*

2. AMENDMENTS TO OPERATING CONDITIONS

Organisation requirements in the UCITS Delegated Act do not establish the details of the integration of sustainability risks within the conduct or business or prudent person rules and due diligence requirements.

(a) Conflicts of interests – the Recital 5 of the delegated Regulation states the following:

"To maintain a high standard of investor protection, management companies should, when identifying the types of conflicts of interest the existence of which may damage the interests of a UCITS, include conflicts of interest that may arise as a result of the integration of sustainability risks in their processes, systems and internal controls. Those conflicts may include conflicts arising from remuneration or personal transactions of relevant staff, conflicts of interest that could give rise to greenwashing, mis-selling or misrepresentation of investment strategies and conflicts of interests between different UCITS managed by the same management company"

Article 17 **Criteria for the identification of conflicts of interest** – the following language is to be added:

"3. Member States shall ensure that, when management companies identify the types of conflicts of interest the existence of which may damage the interests of a UCITS, those management companies include those types of conflicts of interest that may arise as a result of the integration of sustainability risks in their processes, systems and internal controls"

(b) Due diligence requirements

UCITS ManCos should (i) define an investment strategy, (ii) where relevant, identify a proper asset allocation which clarifies how clients' money is allocated in accordance with the investment strategy, (iii) undertake proper due diligence in the selection and monitoring of investments, and (iv) ensure that the portfolios remain in line with the investment strategy and, where relevant, the asset allocation, while integrating sustainability risks.

As sustainability risks are not relevant in the same way for each investment portfolio, the due diligence requirements should be applied in a manner that is appropriate to the investment strategy of the relevant portfolio.

In view of the above, the following language will be added to Article 23(5) and (6):

5. Member States shall require that management companies take into account sustainability risks when complying with the requirements set out in paragraphs 1 to 4.

6. Member States shall require that management companies take into account sustainability risks and, where applicable, the principal adverse impact of investment decisions on sustainability factors when complying with the requirements set out in paragraphs 1 to 4. Where applicable, management companies shall develop engagement strategies including for the exercise of voting rights, where available, with a view to reducing the principal adverse impact of investee companies on sustainability factors.

3. AMENDMENTS TO RISK MANAGEMENT

Risk assessments should consider both financial and relevant sustainability risks. The valuation processes should ensure a proper degree of consideration of relevant/material sustainability risks, but sustainability risk should not be given precedence over other types of risks.

A principles-based approach is the preferred solution as the risk management processes of funds need to be specifically tailored to their investment strategies, the characteristics of the portfolios and the objectives of the underlying investors.

In view of the above, the following language will be added to Article 38(1): *"Member States shall require management companies to establish, implement and maintain an adequate and documented risk management policy which identifies the risks the UCITS they manage are or might be exposed to. The risk management policy shall comprise such procedures as are necessary to enable the management company to assess for each UCITS it manages the exposure of that UCITS to market, liquidity, sustainability and counterparty risks, and the exposure of the UCITS to all other risks, including operational risks, which may be material for each UCITS it manages."*

Amendments to the Shareholders Rights Directive

- (I) ENCOURAGING INVESTORS TO ADOPT A LONG-TERM FOCUS IN THEIR INVESTMENT STRATEGIES, CONSIDER SOCIAL AND ENVIRONMENTAL ISSUES.
- (II) INCORPORATION OF ESG FACTORS IN PUBLIC DISCLOSURES ON INVESTMENT STRATEGIES PUBLISHED BY ASSET MANAGERS AND INSTITUTIONAL INVESTORS.

WHAT IS IT?

The revised Shareholder Rights Directive (“**SRD II**”), amends SRD I which came into effect in 2007 and is aimed at improving corporate governance in EU companies traded on EU regulated markets.

SRD II is aimed at strengthening shareholder engagement, encouraging investors to adopt a long-term focus in their investment strategies, and increase transparency between companies and investors. Recital 14 of SRD II provides that “greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies, including as regards environmental, social and governance factors, in particular as referred to in the Principles for Responsible Investment, supported by the United Nations.”

WHO DOES IT APPLY TO?

- EU-incorporated companies with shares admitted to trading on an EU regulated market. Member State SRD II rules in which the company is incorporated, not in which the company is listed, will apply.
- Institutional investors defined as life insurance, reinsurance or Pillar II pension funds, and occupational pension schemes.
- Asset managers defined as MiFID II portfolio managers, AIFMs, and UCITS ManCos.
- Proxy advisers.
- Intermediaries.

IMPACT - BUY SIDE

Asset managers (comply or explain obligations)

- Engagement policy: develop and publicly disclose on their website, free of charge, an engagement policy that describes (amongst other things) how they monitor investee companies on relevant matters, including non-financial performance and risk, and ESG matters.
- Transparency: make disclosures to the institutional investor, on which it invests on behalf of, concerning (amongst other things) how the asset manager “makes investment decisions on the basis of an evaluation of the medium to long term performance of the investee company including its non-financial performance”. Such information is particularly useful to indicate whether the asset manager adopts a long-term oriented and active approach to asset management and takes ESG matters into account.

³ In the UK, SRD II applies to UK-incorporated companies with a listing of shares on a regulated market elsewhere in the EU, companies with a sovereign controlling shareholder and a premium listing of shares or GDRs under Listing Rule 21; and closed-ended investment funds with a premium listing under Listing Rule 15.

IMPACT - SELL SIDE

Institutional investors (comply or explain obligations)

- Engagement policy: develop and publicly disclose, on their website, free of charge an engagement policy that describes (amongst other things) how they monitor investee companies on relevant matters, including non-financial performance and risk, and ESG matters.
- Transparency: where an asset manager invests on behalf of the institutional investor, the institutional investor must publicly disclose, on their website, free of charge (amongst other things) how the arrangement “incentivises the asset manager to make investment decisions based on assessments about the medium to long-term financial and non-financial performance of the investee company”.

Transparency of proxy advisors (comply or explain obligations)

- publicly disclose on their website, on an annual basis, free of charge (amongst other things) “whether and, if so, how they take national market, legal, regulatory and company-specific conditions into account”, for example ESG factors, in the preparation of the proxy advisor’s research, advice and voting recommendations.

ISSUES TO BE CONSIDERED FURTHER

Listed Companies and directors' remuneration (mandatory obligations)

- Remuneration policy: directors' performance should be assessed using both financial and non-financial performance criteria, including, where appropriate, ESG factors, and explain how they contribute to the company's business strategy, long term interests, and sustainability. Shareholders will have a right to vote on the remuneration policy at the general meeting.
- Remuneration report: a remuneration report which provides a comprehensive overview of each directors' remuneration and how it contributes to the long-term performance of the company, and how each performance criteria was applied, Shareholders of large companies will have a right to cast advisory votes on the remuneration report at the general meeting, and the company shall explain in the following remuneration report how the vote was taken into account. Shareholders of small to medium sized companies will have a right to discuss the report as an agenda item.

DEFINITIONS

"Asset manager" means:

- an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU that provides portfolio management services to investors,
- an AIFM (alternative investment fund manager) as defined in point (b) of Article 4(1) of Directive 2011/61/EU that does not fulfil the conditions for an exemption in accordance with Article 3 of that Directive, or
- a management company as defined in point (b) of Article 2(1) of Directive 2009/65/EC, or an investment company that is authorised in accordance with Directive 2009/65/EC provided that it has not designated a management company authorised under that Directive for its management.

"Director" means: (i) any member of the administrative, management or supervisory bodies of a company; (ii) where they are not members of the administrative, management or supervisory bodies of a company, the chief executive officer and, if such function exists in a company, the deputy chief executive officer; (iii) where so determined by a Member State, other persons who perform functions similar to those performed under point (i) or (ii).

"Intermediary" means a person, such as

- an investment firm as defined in point (1) of Article 4(1) of Directive 2014/65/EU;
- a credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (*); and
- a central securities depository as defined in point (1) of Article 2(1) of Regulation (EU) No 909/2014 of the European Parliament and of the Council (**), which provides services of safekeeping of shares, administration of shares or maintenance of securities accounts on behalf of shareholders or other persons.

"Institutional investor" means

- (i) an undertaking carrying out activities of life assurance within the meaning of points (a), (b) and (c) of Article 2(3) of Directive 2009/138/EC of the European Parliament and of the Council (***), and of reinsurance as defined in point (7) of Article 13 of that Directive provided that those activities cover life-insurance obligations, and which is not excluded pursuant to that Directive;
- (ii) an institution for occupational retirement provision falling within the scope of Directive (EU) 2016/2341 of the European Parliament and of the Council (****) in accordance with Article 2 thereof, unless a Member State has chosen not to apply that Directive in whole or in parts to that institution in accordance with Article 5 of that Directive.

"Proxy advisor" means a legal person that analyses, on a professional and commercial basis, the corporate disclosure and, where relevant, other information of listed companies with a view to informing investors' voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting rights.

EU TIMELINE

2014 – SRD II was proposed.

20 May 2017 – Publication in Official Journal of SRD II – “*Directive (EU) 2017/828 as regards the encouragement of long-term shareholder engagement*”.

4 September 2018 – Publication in Official Journal of “*Implementing Regulation (EU) 2018/1212 as regards shareholder identification, the transmission of information and the facilitation of the exercise of shareholders rights*”.

Transposition / implementation of SRD II took place in phases:

- 10 June 2019 – initial transposition into Member State national laws; and
- 3 September 2020 – transposition of core operational changes applicable to Articles 3A, 3B and 3C.

UK TIMELINE

The FCA implemented measures relating to disclosure by asset managers in relation to the engagement policy and ESG factors were introduced via SYSC 3.4.5 and COBS 2.2B.6 in the FCA Handbook. These came into force in July 2019.

Provisions concerning proxy advisors were onshored in part via the Financial Services (Miscellaneous Amendments) (EU Exit) Regulations 2020 (SI 2020/628). These make amendments to the Proxy Advisors (Shareholders’ Rights) Regulations 2019 (SI 2019/926).

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
SRD II (Directive (EU) 2017/828)	Implementing regulation (EU) 2018/1212	N/A

OVERLAP WITH OTHER ESG REGULATIONS

N/A



Amendments to CRR / CRD

- (I) PERIODIC DISCLOSURE OF ESG, PHYSICAL AND TRANSITION RISKS BY LARGE INSTITUTIONS WITH LISTED ISSUANCES.
- (II) REDUCED OWN FUNDS REQUIREMENTS FOR BANKS' ESG INVESTMENTS.
- (III) POTENTIAL INCLUSION OF ESG RISKS IN SREP FOR BANKS.
- (IV) POTENTIALLY A DEDICATED PRUDENTIAL TREATMENT FOR EXPOSURES TO ESG-LINKED ASSETS IN THE FUTURE.



WHAT IS IT?

Amendments to: (i) the Capital Requirements Regulation (“**CRR II**”); (ii) the Capital Requirements Directive IV (“**CRD V**”) have been introduced by way of an amending regulation and an amending directive.

In relation to ESG amendments, CRR II places a number of obligations on market participants, including disclosure of, and new prudential treatments for ESG risks.

WHO DOES IT APPLY TO?

Credit institutions (Banks) and large or systemically important investment firms which are deemed to be class 1 firms under the IFD/R ([see section 8](#)).

The UK timeframe is delayed compared to EU, but current market expectation is that the provisions will apply to both EU and UK relevant firms (see below for further information).

IMPACT - BUY SIDE

- The buy side would generally not have obligations under CRR II.
- If a buy side firm is in scope for CRR II, see the same impacts as for the sell side, opposite.

IMPACT - SELL SIDE

- **Article 449 report:** Large institutions with publicly listed issuances must disclose ESG risks, physical risks and transition risks as defined in the report referred to in Article 98 of the CRD (see final paragraph below). EBA are to develop a technical standard implementing the disclosure requirements. This disclosure must be made from 28 June 2022, and must be made annually in the first year and every six months thereafter.
- **Reduced prudential exposure:** Banks will have reduced own funds requirements (by a factor of 0.75) for credit risk exposures relating to public infrastructure where the assets contribute to environmental objectives (501(a) CRR II).

- **Monitor prudential treatment of ESG asset risk:** The EBA is to assess whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified (as a component of Pillar 1 capital requirements). This report is due by 2025.
- **Monitor the definition of ESG risks:** The EBA is to report on the definition of ESG risks and their inclusion in the supervisory review and evaluation process performed by competent authorities. This report is due by 28 June 2021. Firms in scope of Article 449 will need to report these risks (see first paragraph above).

ISSUES TO BE CONSIDERED FURTHER

The EBA reports are due in 2021 (on the definition of ESG risks) and 2025 (on prudential treatment of ESG associated assets).

Application to UK banks post-Brexit: The PRA consulted on the implementation of CRD V in the UK ([CP12/20](#)). Under the “onshored” UK CRR, the UK authorities (FCA and PRA) will assume the powers to make future amendments to the CRR/D. Accordingly, the EBA reports and any guidelines recommended by them will not apply directly to the UK regime after Brexit. However, the FCA and PRA may consider the outcome of the EBA reports and UK policy should be monitored in relation to this.

As detailed in the “timeline” section, the UK has announced a target date of 1 January 2022 for implementing the outstanding elements of the CRR II regime. For obligations that require onshoring, the date of application to UK firms may be delayed.

DEFINITIONS

“Environmental objectives” in Article 501(a) CRR II are:

- (i) climate change mitigation;
- (ii) climate change adaptation;
- (iii) sustainable use and protection of water and marine resources;
- (iv) transition to a circular economy, waste prevention and recycling;
- (v) pollution prevention and control;
- (vi) protection of healthy ecosystems.

EU TIMELINE

28 December 2020 – The deadline for member states’ transposition of CRD V.

June 2021 – The new regulations will in general apply.

June 2021 – The EBA report on ESG risks in the SREP is due.

June 2022 – ESG risk reporting by large institutions begins.

June 2025 – The EBA report on prudential treatment of ESG associated assets is due.

UK TIMELINE

The UK government has stated that it has a target date of 1 January 2022 to implement the outstanding elements of the UK-equivalent regime.

This is later than the EU timeline, and therefore the dates at which obligations become applicable to UK firms may also be delayed.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
CRR II (EU 2019/876)	N/A	N/A
CRD V (EU 2019/878)		

OVERLAP WITH OTHER ESG REGULATIONS

The changes apply to banks; UK and EU investment firms will soon be removed from the scope of the CRR with the introduction of the new Investment Firms Regulation and Directive (see “Investment Firm Directive/Regulation” section below).



Investment Firm Directive / Regulation

- (I) POTENTIALLY NEW CAPITAL
TREATMENT FOR ES EXPOSED ASSETS.
- (II) SUPERVISORY EVALUATION OF
INVESTMENT FIRMS' ESG RISK IN
CAPITAL REVIEW.
- (III) REPORTING OF ESG RISK BY
INVESTMENT FIRMS.

WHAT IS IT?

The Investment Firm Directive (“**IFD**”) and Investment Firm Regulation (“**IFR**”) set out the EU’s new prudential framework for investment firms.

In relation to ESG:

- there is a reporting requirement for certain firms to report their ESG risks from 26 December 2022;
- the EBA is required to submit two reports by the end of 2021 with recommendations on:
 - (i) whether to introduce a specific prudential treatment for assets exposed to activities associated environmental or social objectives; and
 - (ii) how to define, review and evaluate firms’ ESG risk as part of the supervisory review and evaluation process, and for the disclosure requirement noted above.

WHO DOES IT APPLY TO?

All Class 1 investment firms (i.e. large global sell-side) will continue to fall under CRR, as above.

The ESG risk reporting and specific prudential treatment of ESG-exposed assets will apply to Class 2 and 3 investment firms.

The requirements to report ESG risk every 6 months will apply to Class 2 and 3 firms with a balance sheet of €100m or more.

Impact Reporting ESG risk: From 26 December 2022, firms with average on and off balance sheet assets of over €100m must disclose information on their ESG risks as defined in the EBA report once in the first year and biannually thereafter (IFR Article 53).

IMPACT - BUY SIDE

- Monitor for EBA report on prudential treatment of exposures of ESG assets.
- Monitor for EBA report on the criteria for identifying ESG risks.
- Measure ESG risks and disclose these periodically from 26 December 2022 (if the firm exceeds the €100m balance sheet test).

IMPACT - SELL SIDE

- Monitor for EBA report on prudential treatment of exposures of ESG assets.
- Monitor for EBA report on the criteria for identifying ESG risks.
- Measure ESG risks and disclose these periodically from 26 December 2022 (if the firm exceeds the €100m balance sheet test).

ISSUES TO BE CONSIDERED FURTHER

To review when EBA reports are completed and the UK response to these is communicated.

The EBA is required to submit two reports to the European Parliament, Council and Commission by the end of 2021. These are to cover:

- (a) Specific prudential treatment (weighting) of ES-related assets:** Whether dedicated prudential treatment of assets exposed to “activities associated substantially with environmental or social objectives” would be justified from a prudential perspective. This would take the form of adjustments to K-factors, meaning ESG exposed assets would be weighted differently from a regulatory capital perspective (Article 34 IFR); and
- (b) Supervisory review/evaluation of ESG Risk:** Introducing criteria for environmental, social and governance (ESG) risks, how investment firms can take account of these risks in their risk management and how supervisors can assess the impact of those risks in their Supervisory Review and Evaluation Process (SREP). Based on this report, the EBA may choose to adopt guidelines to introduce criteria for ESG-related risks into the SREP for both Class 2 and 3 investment firms. (Article 35 IFD).

The Commission may then bring forward legislative proposals on the basis of these reports.

Brexit – impact on UK firms: The EBA reports and any guidelines recommended by them will not apply directly to the UK prudential regime after Brexit. The FCA has said in DP20/2 that it will consider the findings of the EBA in these areas and consider introducing additional FCA guidelines if they are deemed necessary.

DEFINITIONS

“ESG Risk” is to be defined by the EBA report, but the regulations suggest it should include “physical risks and transition risks related to the transition to a more sustainable economy, and, with regard to transition risks, including risks related to the depreciation of assets due to regulatory change”.

EU TIMELINE

EBA Reports due 26 December 2021.

ESG risk disclosures must be made from 26 December 2022.

UK TIMELINE

The UK government has stated that it has a target date of 1 January 2022 to implement the UK-equivalent regime.

This is six months later than the EU timeline, and therefore the dates at which obligations become applicable to UK firms may also be delayed.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
Investment Firms Directive (EU 2019/2034) Investment Firms Regulation (EU 2019/2033)	UK: Expected in 2021 EU: Draft RTS	TBC

OVERLAP WITH OTHER ESG REGULATIONS

Class 1 investment firms fall in CRR/D.



Amendments to PRIIPs

WHERE A KID STATES A PRIIP TARGETS ENVIRONMENTAL OR SOCIAL OBJECTIVES THE MANUFACTURER MUST DEMONSTRATE THE SUBSTANCE OF THOSE OBJECTIVES.

WHAT IS IT?

The Regulation on key information documents (“**KID**”) for packaged retail and insurance-based investment products (PRIIPs) (1286/2014) (“**PRIIPs Regulation**”) refers to ESG factors. Specifically, where a KID states that a PRIIP targets environmental or social objectives, the manufacturer must be able to demonstrate to potential retail investors and other stakeholders, including supervisors and market participants, the substance of these objectives and how they are to be met throughout the investment process and the lifetime of the PRIIP.

In July 2017, The Joint Committee of the ESA’s released technical advice to the Commission on the procedures which should be used to establish whether a PRIIP targets specific environmental or social objectives but decided against standalone obligations in relation to PRIIPs targeting specific ESG objectives and it stated that specific environmental or social objectives should be treated on equal footing with other investment objectives. A review by of PRIIPs Regulation by the European Commission is due under the provisions of the PRIIPs Regulation. This may present an opportunity to revisit this issue.

WHO DOES IT APPLY TO?

All firms which manufacture or advise on or sell PRIIPs. PRIIPs manufacturers must prepare a KID in a prescribed format. These requirements in the PRIIPs regulation are relevant to the content of KIDs, so apply to manufacturers, being the firms required to prepare KIDs.

IMPACT - BUY SIDE

- Firms which manufacture financial products would need to consider if such products remain consistent with the ESG preferences of the target market, and update their relevant KIDs to take account of ESG considerations and risks accordingly.
- Update KID for ESG.
- Ensure product is consistent with the ESG profile of the PRIIP.

There is a connection between these requirements and the product governance requirements in MiFID II. Firms should ensure consistency between these.

IMPACT - SELL SIDE

- Update KID for ESG.
- Ensure product is consistent with the ESG profile of the PRIIP.
- There is a connection between these requirements and the product governance requirements in MiFID II. Firms should ensure consistency between these.

EU TIMELINE

July 2017 – following a consultation, the ESAs concluded that it would not in general be proportionate to establish specific and detailed standalone obligations at that time for PRIIPs that target specific environmental or social objectives.

UK TIMELINE

No action has been announced.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
PRIIPs Regulation	N/A	ESA Technical Advice JC 2017 43

OVERLAP WITH OTHER ESG REGULATIONS

The PRIIPs Regulation overlaps with AIFMD, MiFID II and the Insurance Distribution Directive.



Amendments to the Prospectus Regulation

IMPOSES REQUIREMENTS ON CERTAIN ISSUERS OF SECURITIES TO PREPARE A PROSPECTUS.

WHAT IS IT?

The Prospectus Regulation 2017/1129 requires disclosure of ESG factors where these may have a material impact on the issuer, such as on its assets and liabilities, profits and losses, financial position or prospects.

Recital 54 of the Prospectus Regulation addresses risk factors that are required by the Prospectus Regulation and makes specific reference to environmental, social and governance factors.

Some annexes (e.g. item 5.7.4. Annex 1) to the Commission Delegated Prospectus Regulation (EU 2019/980) require relevant disclosures including an overview of the business and a description of the regulatory environment.

WHO DOES IT APPLY TO?

All firms which are subject to the requirement to publish a prospectus in accordance with the Prospectus Regulation.

IMPACT - BUY SIDE

- Where firm is listed under the Prospectus Regulation it should disclose ESG risks where material.

IMPACT - SELL SIDE

- Where firm is listed under the Prospectus Regulation, it should disclose ESG risks where material.
- Where firm is advising (corporate finance) it should ensure that its client takes into account ESG risk in any prospectus it produces.

ISSUES TO BE CONSIDERED FURTHER

Announcements by regulators in relation to ESG and the Prospectus Regulation should be monitored. We expect further guidance on ESG considerations in prospectuses.

DEFINITIONS

N/A

EU TIMELINE

The Prospectus Regulation has been fully in effect in all member states since 21 July 2019.

ESMA issued a set of Guidelines on risk factors under the Prospectus Regulation in October 2019. Guideline 7 on the presentation of risk factors across categories is accompanied by explanatory paragraph 35 which states that ESG-related risks could form a specific category of risk.

In July 2020, ESMA issued also issued its Final Report “ESMA Guidelines on disclosure requirements under the Prospectus Regulation” These update previous recommendation issued by CESR. Guideline 3 provides that the OFR should include details on returns to shareholders and information to allow investors to assess the sustainability of future earnings and cash flow (including impact of ESG factors). ESMA confirmed that the Guidelines would become effective two months after their publication on ESMA’s website in all the official languages of the EU. The Guidelines had not been published in all of the EU official languages by 1 November 2020.

UK TIMELINE

Aspects of Prospectus Regulation were onshored by Official Listing of Securities, Prospectus and Transparency (Amendment etc.) (EU Exit) Regulations 2019 the Prospectus (Amendment etc.) (EU Exit) Regulations 2019.

FCA expects firms to continue to make every effort to comply with any guidelines and recommendations that they are currently expected to comply with to the extent that they remain relevant following IP Completion Day.

The July 2020 Guidelines on disclosure requirements are not effective before the end of the Transition Period.

The FCA has indicated in Policy Statement on Brexit (PS 19/5) that it may consider materials produced by the ESAs post-exit, including where pre-exit material is updated. It has confirmed that it will consult on its approach to the guidelines on prospectus disclosure based on the new ESMA Guidelines.

In December 2020, the FCA issued a [Technical Note](#) “Disclosures in relation to ESG matters, including climate change”. This contains guidance on how ESG matters may be relevant for disclosures under the Prospectus Regulation.

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
<u>Prospectus Regulation 2017/1129</u>	<u>Commission Delegated Regulation (EU) 2019/980</u> <u>Commission Delegated Regulation (EU) 2019/979</u>	<u>Questions and Answers on the Prospectus Regulation (ESMA31-62-1258)</u> <u>Final Report: ESMA Guidelines on disclosure requirements under the Prospectus Regulation (ESMA31-62-1426)</u> <u>Guidelines On Risk factors under the Prospectus Regulation (ESMA31-62-1293)</u> <u>Questions and Answers -Prospectuses – 30th updated version – April 2019 (ESMA31-62-780)</u> <u>ESMA Guidelines on Alternative Performance Measures (ESMA/2015/1415)</u> ESMA Q&A: Guidelines on Alternative Performance Measures (ESMA32-51-370)

OVERLAP WITH OTHER ESG REGULATIONS

N/A



Amendments to Non-Financial Reporting Directive

NON-BINDING GUIDELINES WHICH
ASSIST COMPANIES IN DISCLOSING
CLIMATE-RELATED INFORMATION.

WHAT IS IT?

Non-binding guidelines set out in a Communication from the Commission. It complements the Non-Financial Reporting Directive (2014/95/EU) which requires large public interest companies to publish reports policies they implement in a range of areas, including environmental protection, social responsibility and diversity.

The guidelines propose climate related disclosures for each of the five reporting areas in the Non-Financial

Reporting Directive. These include describing the ways in which the company's business model can impact the climate, both positively and negatively, describing any climate-related targets the company has set as part of its policies and describing the company's processes for identifying and assessing climate-related risks over the short, medium, and long term.

WHO DOES IT APPLY TO?

The Non-Financial Reporting Directive applies to Public Interest Entities with over 500 employees.

IMPACT - BUY SIDE

When selecting financial instruments, buy side firms may make use of disclosures required under the Non-Financial Reporting Directive in relation to underlying companies within investment products.

IMPACT - SELL SIDE

This does not directly affect the sell side. However it may impact on whether PIEs which are included within investment products (for example, within ETFs) meet the environmental objectives of investors. This non-binding guidance may provide a useful measure of a company's environmental impact, which would carry through to the rating of the relevant ETF.

ISSUES TO BE CONSIDERED FURTHER

The guidelines here are non-binding, however it may be the case that market standards and expectations adapt based on the guidelines.

DEFINITIONS

N/A



EU TIMELINE

The guidelines under the NFRD were updated on 20 June 2019.

UK TIMELINE

TBC

SOURCES

LEVEL 1	LEVEL 2	LEVEL 3
Non-Financial Reporting Directive	N/A	Guidelines on non-financial reporting (methodology for reporting non-financial information) (2017/C215/01) Guidelines on non-financial reporting: Supplement on reporting climate-related information (2019/C209/01)

OVERLAP WITH OTHER ESG REGULATIONS

Taxonomy Regulation.



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